U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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TESTIMONY OF DEPUTY ASSISTANT SECRETARY JEREMIAH O. NORTON BEFORE THE U.S. HOUSE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

WASHINGTON- Thank you, Chairman Kanjorski, Ranking Member Pryce, and Members of the Subcommittee for inviting me to appear before you today to discuss the *Insurance Information Act of 2008* (H.R. 5840; Discussion Draft as of June 4, 2008).

The Need for Insurance Regulatory Modernization and Treasury's Blueprint Recommendations

Insurance performs an essential function in our domestic and global economies by providing a mechanism for businesses and individuals to safeguard their assets from a wide variety of risks. Insurance is similar to other financial services in that its cost, safety, and ability to innovate and compete is heavily affected by the substance and structure of its system of regulation.

Unlike banks and other financial institutions that are regulated primarily at the federal level or on a dual federal/state basis, insurance companies in the United States are regulated almost entirely by the States. Over time, the business of providing insurance has developed a more national focus, and the insurance marketplace has become global in nature. The state-based regulatory structure inherently makes the process of developing national products cumbersome and competing in the global marketplace more costly.

On March 31, the Treasury Department ("Treasury") released a report on financial services regulation entitled *Blueprint for a Modernized Financial Regulatory Structure* ("Blueprint"). In addition to making recommendations for a long-term "optimal" regulatory structure, the Blueprint also presents a series of "short-term" and "intermediate-term" recommendations that could, in Treasury's view, improve and reform the U.S. financial services regulatory structure – including the current state-based regulation of insurance.

In the intermediate-term, Treasury recommends the establishment of an optional federal charter (OFC) for insurance. The establishment of an OFC structure would provide insurance market participants with the choice of being regulated at the national level or of continuing to be regulated by a State. A properly constructed OFC insurance regulatory structure should: enhance competition among insurers in national and international markets; increase efficiency; promote more rapid technological change; encourage product innovation; reduce regulatory costs; and provide strong consumer protection.

There currently are pending bills in both the House (H.R. 3200) and Senate (S. 40) entitled "The National Insurance Act of 2007" that would create an OFC and establish a regulator within Treasury.

These bills contain many of the core concepts surrounding the establishment of an OFC structure as envisioned in the Blueprint. We look forward to evaluating further the specific provisions of these bills as they move forward.

While an OFC offers the best opportunity to develop a modern and comprehensive system of insurance regulation, Treasury acknowledges that the OFC debate in the Congress is ongoing. At the same time, however, Treasury believes that some aspects of the insurance regulatory regime require immediate attention. In particular, Treasury recommends that the Congress establish an Office of Insurance Oversight within Treasury. This newly established office would be able to focus immediately on key areas of federal interest in the insurance sector, including international insurance issues.

International Insurance Issues

The insurance marketplace operates globally with many significant foreign participants. There is increasing tension among current regulatory systems due to an absence of a clear and settled means for governments to recognize the equivalency of prudential regulation of insurance and reinsurance companies seeking to provide services in other countries. This impairs the ability of U.S.-based firms to compete abroad and the allowance of greater participation of foreign firms in U.S. markets.

In particular, foreign government officials have continued to raise issues associated with the United States having at least 50 different insurance regulators, which makes coordination on international insurance issues difficult for foreign regulators and companies. The National Association of Insurance Commissioners (NAIC) has attempted to fill this void by working closely with international regulators in various areas. The NAIC itself is not a regulator but facilitates communications among the States on many issues, including international insurance regulation. Nevertheless, it is becoming increasingly difficult for the United States to speak consistently and effectively with one voice.

It has become clear to Treasury that there is an immediate need to establish an insurance-sector advisor at the federal level, as well as to create a federal framework to address emerging international insurance regulatory issues. Two examples of such a need include: (1) reinsurance collateral and the perceived unequal treatment of certain foreign reinsurers; and (2) the European Union's (EU) Solvency II directive and how that may impact the competitive position of U.S. firms in Europe.

Reinsurance Collateral

States indirectly regulate unlicensed, non-U.S. reinsurers by setting out the circumstances under which U.S. licensed insurers may take financial statement credit for the reinsurance. Based primarily on the NAIC's model law and regulation, States generally require that unlicensed, non-U.S. reinsurers provide 100 percent collateral to secure their U.S. obligations. By contrast, within the EU, the European Commission through its Reinsurance Directive is eliminating collateral requirements among its EU reinsurers, but not necessarily among non-EU reinsurers.

Non-U.S. reinsurers, foreign government officials, and EU representatives believe such cross-border collateral requirements should be reduced or eliminated between jurisdictions of equivalent regulatory reinsurance supervision. Many believe that there is a strong rationale for this view, and in response, various state insurance commissioners have launched a series of efforts to address the issue and find a pragmatic solution, only to see each of these efforts founder.

Solvency II

Last year, the EU published its Solvency II Framework Directive, which seeks to develop a single EU-wide market in insurance services, create a consolidated oversight structure with strong home country lead supervision of both prudential and regulatory capital authority, and secure a high degree of consumer protection. Solvency II is expected to be adopted by the end of 2008, and EU Member States are expected to implement the directive by 2012. The framework creates a risk-based system for assessing regulatory capital for all insurers and reinsurers on a consolidated basis across all EU Member States, similar in concept to the Basel II framework applicable to banks.

As the EU continues to move toward the implementation of this oversight framework in the insurance sector, it is becoming more apparent that the framework potentially will be at odds with the U.S. regulatory structure for insurance. In particular, it is unlikely that the EU would find the current U.S. state-based regulatory structure "equivalent" for purposes of allowing U.S. insurers to operate within the EU, meaning that U.S. companies operating in Europe would face unspecified regulatory measures that would increase the costs of their operations and place them at a competitive disadvantage.

These issues – reinsurance collateral and Solvency II – have been under discussion for many years between U.S. and European authorities through numerous channels. Despite good and cooperative efforts by all parties, we are seemingly no closer today to finding pragmatic solutions than we were several years ago.

Office of Insurance Oversight within Treasury

As called for by the Blueprint, the Office of Insurance Oversight (Office) would focus immediately on key areas of federal interest in the insurance sector by serving as an advisor to the Secretary of the Treasury on major domestic and international insurance regulatory issues. The Office would also be provided with authority to address international regulatory issues.

Such an office would be able to focus immediately on key areas of federal interest in the insurance sector without the need to create a federal regulatory structure. It would advise the Secretary of the Treasury on major domestic and international policy issues, provide true national regulatory expertise and guidance on the insurance industry and how it relates to the overall economy, and provide such expertise and guidance on legislative issues pending before the Congress.

The Office should be empowered to address international regulatory issues with foreign regulators, a role that is not being played in the non-consolidated state-based regulatory system. In this role, the Office should be the lead in working with the NAIC and state insurance regulators, who would still be primarily responsible for implementing insurance regulatory policies.

For example, the Office could lead the discussions with international regulators on international regulatory issues to develop regulatory agreements that provide for recognition of substantially equivalent prudential measures and regulatory systems with respect to insurance and reinsurance services. This would include recognition agreements providing for reliance upon facets of relevant foreign regulatory systems. Overall, the establishment of federal involvement in these types of agreements would allow for the United States to engage more consistently in dialogue with foreign regulators and enhance the prospects for resolving issues.

The role that the Office would play in U.S. negotiations with foreign governments, authorities, or regulators would be to bring its insurance expertise to the table along with a well-developed uniform U.S. position on insurance regulatory policy. Its focus would be on regulatory matters that are not presently addressed at the federal level. It would not supplant the Commerce Department or other relevant Executive Branch agencies, but would work closely with them. The United States Trade Representative would remain the chief representative of the United States for international trade negotiations, including all negotiations on any matter considered under the auspices of the World Trade Organization and commodity and direct investment negotiations.

As we suggested in the Blueprint, some degree of preemptive authority will be necessary if international regulatory agreements are going to be effective. A number of approaches to preemption could be considered, but a key aspect of establishing the Office is to improve the ability of the United States to deal more effectively with international insurance regulatory issues. Whatever the degree of preemption, the establishment of this Office should further that goal.

Treasury welcomes the introduction of H.R. 5840, the *Insurance Information Act of 2008*, by Subcommittee Chairman Kanjorski and Ranking Member Pryce. This bill would create an office within Treasury very similar to that recommended in the Blueprint.

Overall, Treasury supports the bill's creation of the Office of Insurance Information. Treasury has some concerns, however, we are confident that we can continue to work together to address these as this legislation moves forward.

Conclusion

We appreciate the efforts of the Chairman and Members of the Subcommittee. We look forward to continuing to work with you and the Congress on this important legislation. Thank you.

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